No. 15,326

United States Court of Appeals

For the Ninth Circuit

RALPH E. WILLIAMS, as Trustee of the Estate of Future Mfg. Cooperative, Inc., Bankrupt,

Appellant,

vs.

LEAMON T. McDONALD,

Appellee.

APPELLANT'S OPENING BRIEF.

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STATEMENT OF JURISDICTION.

Appellant filed a complaint in the United States District Court for the Northern District of California, Southern Division (T.R., p. 3) to recover a preference from Appellee pursuant to the provisions of Section 60 (a)-(b) of the Bankruptcy Act (11 U.S.C.A. 96(a)-(b)). On August 27, 1956, the District Court rendered its judgment in favor of Appellee (T.R., p. 9). Notice of appeal therefrom was filed August 29, 1956 (T.R., p. 10). The appeal was timely filed (11 U.S. C.A. 48).

STATEMENT OF THE QUESTION PRESENTED.

The question before the Court is whether or not Appellee, president, general manager and operator of the bankrupt corporation, had reasonable cause to believe that the bankrupt corporation was insolvent at the time that he paid himself (from the bankrupt's funds) the past due salary within thirty days prior to the filing of the voluntary petition in bankruptcy, so that such payment would constitute a preference within the meaning of the Bankruptcy Act.

STATEMENT OF FACTS.

On January 30, 1956, a voluntary petition in bankruptcy was filed by Future Mfg. Cooperative, Inc., in the United States District Court for the Northern District of California, Southern Division, in proceeding therein numbered 46033 and thereafter Future Mfg. Cooperative, Inc., was duly adjudged a bankrupt. During the night of January 2, 1956, the business operated by the bankrupt corporation was destroyed by fire (T.R., p. 13). On January 4, 1956, Appellee received the receipts for the operation of the business for the week prior to the fire, and he paid to himself the sum of $1,776.00 for back wages (T.R., pp. 13 and 14). At the time of this payment Appellee was the president, general manager and operator of the business (T.R., p. 13).

ARGUMENT.

I. THE DISTRICT COURT ERRED IN FINDING THAT APPELLEE DID NOT HAVE KNOWLEDGE OR REASONABLE CAUSE TO BELIEVE THAT THE BANKRUPT CORPORATION WAS INSOLVENT AND IN CONCLUDING THEREFROM THAT THE PAYMENT OF $1,776.00 TAKEN BY APPELLEE WITHIN FOUR MONTHS OF THE FILING OF THE PETITION IN BANKRUPTCY ON ACCOUNT OF HIS PAST DUE WAGES WAS NOT PREFERENTIAL.

The Court made the following finding of fact (T.R., p. 7):

> "(II) That each and all of the allegations contained in paragraph III of said Plaintiff's Complaint are true, saving and excepting the words 'Defendant well knew and/or had reasonable cause to believe that said transferor was insolvent,' and that said exception is untrue."

and concluded therefrom (T.R., pp. 7 and 8):

> "(I) That the payment by the Bankrupt to the Defendant of the sum of $1,776.00 within four months next preceding the filing of the petition in bankruptcy by said Bankrupt on the 30th day of January, 1956, was not a voidable preference under Section 60(b) of the Bankruptcy Act, and that said Defendant did not have knowledge or reasonable cause to believe that said Bankrupt was insolvent at the time of said payment.
>
> (II) That Plaintiff is not entitled to recover the said sum of $1,776.00 from Defendant."

The finding and the conclusions herein above quoted raise the sole question of this appeal. It is Appellant's contention that the finding is erroneous as a matter of law and that, therefore, the conclusion must fall.

The District Court found that, among other things, *the bankrupt corporation was insolvent at the time of the payment of the past due salary by Appellee to himself* (T.R., p. 7), in that the Court found the allegation "while then and there insolvent" contained in paragraph III of Appellant's Complaint (T.R., p. 4), to be true. The finding of insolvency is well supported by the evidence and testimony presented in the trial of the issue (T.R., pp. 14 and 15; T.R., pp. 21 and 22; and T.R., p. 29) (Plaintiff's Exhibit No. 1). Therefore the sole issue present is the question of the reasonable cause of Appellee to believe the bankrupt was insolvent.

(1) Appellee had reasonable cause to believe the bankrupt to be insolvent at the time he took the preferential payment.

A preference within the meaning of the Bankruptcy Act and the Trustee's right to avoid a preference is established by Section 60(a)-(b) of the Bankruptcy Act (11 U.S.C.A. 96(a)-(b), which read, in part, as follows:

Section 60a(1)

> "A preference is a transfer, as defined in this Act, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this Act, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class."

Section 60b

> "Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property, except a bona-fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value . . ."

Some Courts, apparently including the District Court here[1] have erroneously required "actual knowl-

[1]"The Court. Mr. Aaronson, there is no evidence that would justify that this money was taken with knowledge of bankruptcy.

Mr. Aaronson. Insolvency, not bankruptcy. The witness testified that there was no operation subsequent to the fire and that the assets and liabilities of the corporation were exactly the same at the time of the fire, which was before the taking of the money, as they were at the time of the filing of the petition. The schedules show almost two to one on the liability side.

And I might further add that an examination of the B side of the schedules, the assets, will show $24,000 set up as property—personal property and equipment—of which there was none, other than a few items, which incidentally are listed as amounts unknown, which were not on the premises destroyed by the fire, and also include the $1,900 that Mr. McDonald got. So if you reduce that, you have 80 odd thousand dollars, less——

The Court. On the figures, yes, but the witness has testified that they thereafter were intending to continue with the business, which would not indicate an insolvency. You put him on. That is his testimony.

Mr. Aaronson. I appreciate that, your Honor; but the question of insolvency is the excess of the liabilities over the assets.

The Court. That is true, but in recovering a preference the burden is to show——

Mr. Aaronson. Reasonable cause to believe they were solvent.

The Court. ——reasonable cause to believe that the concern was involvent.

Mr. Aaronson. Mr. McDonald testified only that they were going to try to continue on, and he was president and operated the

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> "Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property, except a bona-fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value . . ."

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The Court. ——reasonable cause to believe that the concern was involvent.

Mr. Aaronson. Mr. McDonald testified only that they were going to try to continue on, and he was president and operated the

edge'' of insolvency rather than ''reasonable cause to believe that the debtor is insolvent'' and have confused ''insolvency'' with ''bankruptcy'' notwithstanding the

business, and he well knew the condition of the business, and that there was no operation, so that the business, as the records show in the schedules, was in exactly the same condition at the time the petition was filed as it was at the time he took the money.

The Court. The only circumstance is that this $1,700 was paid after the fire when the business was inoperative. That is the only circumstance.

Mr. Aaronson. I might say——

The Court. I have grave doubts as to whether or not there would be a preponderance of evidence that would be sufficient to warrant a finding that that was a preferential payment under the statute. There is a slimness of any evidence except the circumstance that here was a business that was apparently going along then there was a fire, and then it was closed down for a time, and this man says he needed the money because he had been devoting himself to operating this business, so he took the back salary at that time. I have doubts as to whether or not that circumstance is sufficient to warrant the inference that he took the money at that time with the awareness that the business was insolvent and that the effect of what he was doing was getting a preference over somebody else."

(T.R., pp. 28, 29 and 30.)

"The Court. There is a very slim record here, Mr. Aaronson and it doesn't seem to me to be sufficient to warrant adjudging a repayment of this as a preference. The only circumstance is that after the fire and before anything further was done, then he received the past due wages that were due him. That is all that the record shows.

Now we would have to indulge in the assumption at that time that that payment was made that the concern was insolvent; that he knew it was insolvent; that he took this money and got this money knowing that he was being preferred to other creditors at the time." (Emphasis added.)

"Mr. Aaronson. I think that is what the record shows, your Honor, exactly.

The Court. His own testimony doesn't indicate that he had any awareness that there was an insolvency.

Mr. Aaronson. I think his testimony is in conflict with the evidence, your Honor. I appreciate it is a matter of testimony but the schedules show—it was his testimony that the business conditions did not change from the time of the fire until the time the petition was filed, and these schedules which were subscribed and sworn to and filed, were taken from the books which

language of Section 60 of the Bankruptcy Act hereinabove set forth. See 3 *Collier on Bankruptcy* 14th Ed., Section 60.53, p. 989:

show the condition at that time, and as I indicated to your Honor, it shows of the $44,000 on the asset side over $24,000 is not in existence.

The Court. $24,000 and what?

Mr. Aaronson. Was not in existence, because it includes some 24,000 odd dollars of equipment and supplies and so on that were destroyed in the fire. It also shows the fire insurance, which is actually the only asset, and it shows the $1,900 in Mr. McDonald's possession, which it is not."

(T.R., pp. 32 and 33.)

"The Court. ——that since he testified that the assets were the same and the liabilities were the same on the date the bankruptcy petition was filed as they were on the day that he received the money, that, theoretically, the argument is that he must have been aware of that condition.

Mr. Aaronson. As the president of the concern.

The Court. His testimony is, however—and it is uncontroverted—that he didn't want to go into bankruptcy at the time; that he was opposed to it, and that finally he did.

Mr. Aaronson. Yes.

The Court. I mean, that is his testimony.

Mr. Aaronson. His testimony was that they thought——

The Court. The bankruptcy petition was not filed until the 16th or 17th, I think.

Mr. Aaronson. It actually wasn't filed until the 30th. The resolution was adopted on the 15th.

The Court. Yes.

Mr. Aaronson. I also know why it was adopted, but I think that is a matter that is not involved here. It was his testimony, your Honor, that they were going to try to work it out and have a fire sale. That was his testimony. It is uncontroverted because I wasn't present at any of the meetings—they were going to attempt to continue and have a fire sale and work it out with the creditors and continue. Of course it was our contention that what the intentions of the parties are, the good or bad intentions of the parties, is not an element to be considered. It is purely a question of whether or not the bankruptcy act was violated——

The Court. It is a question of whether or not there was knowledge——

Mr. Aaronson. ——and it is our contention that it was, because he was president and general manager and he well knew the condition of the business."

(T.R., pp. 34, 35 and 36.)

"Knowledge of insolvency is not necessary, nor even actual belief thereof; all that is required is a reasonable cause to believe that the debtor was insolvent at the time of the preferential transfer. *A creditor has reasonable cause to believe that a debtor is insolvent when such a state of facts is brought to the creditor's notice respecting the affairs and pecuniary condition of a debtor, as would lead a prudent business person to the conclusion that the debtor is insolvent.*" (Italics ours.)

Thus, if the facts are sufficient to put a prudent business person on notice, he is chargeable with notice of all the facts which reasonably diligent inquiry would have disclosed.

Here, the Appellee was the president, general manager and operator of the bankrupt corporation which was a small grocery store and was in a far better position than any other creditor to know the financial condition of the corporation. When Appellee took the preferential payment, he was well aware of the fact that the business had been destroyed by fire, and that there were other creditors in existence and that no payments were made to them. Appellant cannot conceive that the Appellee, president, general manager and operator of the business, did not know about the company's insolvency. In any event, such an officer is *presumed* to have such knowledge.

Matter of W. A. Silvernail Co., 218 Fed. 978, 33 Am. Br. 59;

Irving Trust Co. v. Roth, D.C., N.Y., 48 F. 2d 345;

Cohen v. Tremont Trust Co. (D.C. Mass.), 256 Fed. 399, aff'd 263 F. 81;

New York Credit Men's Ass'n v. Hasenberg (D.C., N.Y.), 26 F. Supp. 877, aff'd 107 F. 2d 1020;

In re Plant, 148 Fed. 37.

It appears apparent that the District Court must have used its own interpretation concerning proof of insolvency and reasonable knowledge thereof on behalf of Appellee with the result that the Court reached a decision which in effect permits an officer of a corporation on whom creditors must rely on their business dealings to take advantage of his position and knowledge to fill his own pocket at the creditors' expense.

CONCLUSION.

In view of the law and the facts as hereinabove set forth, it is Appellant's contention that the finding and conclusions of the trial Court (T.R., pp. 7 and 8) are unsupported by the evidence and are contrary to law. We feel that the purpose of the preference law is to prevent a depletion of the insolvent debtor's estate by transfers to any creditors who have either knowledge of or reasonable cause to believe in the debtor's insolvency at the time of receipt of such payments. We believe that such recoveries should be had, regardless of the amount involved, and that *to condone the trial Court's judgment in this case would be to encourage, rather than discourage, corporate officers, with knowl-*

edge of a failing business, to withdraw as much of th corporation's cash prior to bankruptcy as their bac salaries or other personal claims as creditors coul possibly permit. This is not consistent with the right of creditors generally which the Bankruptcy Act i designed to protect. For these reasons we believe th trustee in bankruptcy must bring actions such as thi even though the amounts involved may individuall be small, because when added together, they woul substantially increase the fund to which genera creditors could look for recovery on their claims.

It is, therefore, respectfully submitted that the judg ment of the District Court of August 2, 1956, shoul be reversed.

Dated, San Francisco, California,
January 25, 1957.

Respectfully submitted,
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By ARTHUR P. SHAPRO,
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